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IN THE

# Supreme Court of the United States

OCTOBER TERM—1944

No. 612

SPENCER, WHITE & PRENTIS, INC.,
Petitioner,

*against*

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

Spencer, White & Prentis, Inc. respectfully submits this petition and prays that a writ of certiorari issue to review the decision and mandate of the United States Circuit Court of Appeals for the Second Circuit herein which affirmed an order of the Tax Court of the United States which in turn "Ordered and Decided: That there are deficiencies in income and excess profits tax in the amounts of $79,824.41 and $34,049.38 respectively for the fiscal year July 1, 1937, to June 30, 1938."

### Opinions Below

The Memorandum Findings of Fact and Opinion of the Tax Court of the United States are dated June 21, 1943, and a copy thereof is hereunto annexed made a part hereof, and marked Appendix A.

The Opinion of the United States Circuit Court of Appeals for the Second Circuit is dated July 10, 1944, and a copy thereof is hereunto annexed made a part hereof and marked Appendix B.

## Summary Statement of the Matters Involved

This proceeding concerns a proposed deficiency in income and excess profits taxes sought to be sustained by respondent against petitioner for its fiscal period July 1, 1937—June 30, 1938.

The letter of respondent claiming such deficiency is dated June 6, 1941. From such proposed adjustment of petitioner's tax liability, petitioner appealed to the Tax Court of the United States by petition verified August 18, 1941.

From the determination of the Tax Court petitioner appealed to the United States Circuit Court of Appeals for the Second Circuit by petition verified September 8, 1943.

The said Circuit Court of Appeals sustained the action of the Tax Court herein.

Petitioner moved for reargument on July 20, 1944, which motion the Circuit Court of Appeals denied without opinion by order dated July 26, 1944.

## Jurisdiction

The mandate of the Circuit Court of Appeals for the Second Circuit was entered herein on July 27, 1944. The jurisdiction of this Court is founded on Section 347-a of the United States Judicial Code.

## The Facts Herein

The facts herein, insofar as a recital thereof is necessary to an understanding of the questions involved herein are as follows:

Petitioner is a contracting corporation which regularly performs short term construction contracts and from time to time performs long term construction contracts. It has always reported its income on the annual accrual basis.

In 1933 it was engaged in performing a long term construction contract for the United States along the Mississippi River. The form of such contract resulted in its being prepaid in one period for construction work it was obligated to perform in a later period.

It then (1933) applied to respondent for permission to report its long term contracts on a completed contract basis. The Commissioner denied this application on two grounds: (a) that it was not made within a ninety-day period after the close of petitioner's fiscal period, (b) that "an election with respect to the basis of reporting income from each separate long-term contract is no longer permissible."

It thereupon, for 1933-1934 reporting, accrued all of the income earned by it, that is, the value of all work performed by it, including the value of work performed and not certified and the amount of net retained percentages, and returned the sum of these as assets and income.

It also, for 1933-1934 reporting, accrued all liabilities, including the cost of performing the work for which it had been prepaid. These it returned as liabilities and expenses.

In the above manner of reporting respondent acquiesced.

On June 30, 1938 petitioner was faced with the identical situation it faced in 1933-1934. At this time the contract in question was a New York City subway contract. It was then pointless to again apply to the respondent for leave to report the contract in question as a long-term construction contract. In its reporting for the fiscal period ending June 30, 1938, petitioner reported exactly as it did as of June 30, 1934.

It reported as assets and income

| | |
|---|---|
| (a) Moneys earned under contract certified and paid | $3,002,303.34 |
| (b) Money earned under contract certified but retained by the City of New York pursuant to the contract | 529,818.24 |
| (c) Money earned under contract but not yet certified | 321,519.85 |

It reported as liabilities and expenses:

| | |
|---|---|
| (a) Costs paid and accrued (as to these items there is no question) | 2,860,110.76 |
| (b) Expenses and liabilities accrued | 327,500.00 |

Said item of $327,500 was the estimate of the cost of performing the work for which petitioner had been prepaid under the contract in question.

Respondent conceded that the accrual of $327,500 was an accurate and reasonable estimate, but disallowed the same as a deduction for the year in question.

Petitioner's evidence before the Tax Court, as the record shows, was substantially unquestioned and was amply corroborated by documentary evidence.

The opinion of the United States Circuit Court of Appeals Second Circuit sets forth these facts as follows:

> "The total of $3,853,641.43 included by the taxpayer as gross income in its return for the fiscal year in question covered not only the contract price for pay items completed but some non-pay items yet to be performed. This resulted from the fact that the cost of non-pay items was included in the cost of pay items.
>
> "The taxpayer accrued on its books* as of June 30, 1938, the sum of $327,500 as a 'liability to restore property under contracts' which was the estimated

* This is the language used in the income tax return Pet.'s Ex. 1. The books carry this as "Contract 761 Deferred for incurred expense as of 6/30/38 on Route 101 Sec. 6, as estimated by E. A. Prentis, Chief Eng. as follows * * *" Pet.'s Ex. 17.

cost of items which it had carried in its accrual of gross income. This amount of $327,500 it deducted in its tax return as 'increased* expenses.' But this amount did not represent obligations due to sub-contractors, materialmen, laborers or other creditors and was an estimate of the cost of work under the contract performed after June 30, 1938, at a cost of $339,090.40."

## Questions Presented

This application brings before this Court departures by the Tax Court of the United States and the Circuit Court of Appeals for the Second Circuit from principles well established and followed by this Court as to the construction of Sections 21, 23, 41, 42 and 43 of the Revenue Act of 1936 (similar in prior and subsequent Revenue Acts) and Regulations 94 Article 21 (d), 23 (a)-1, 41-1, 41-2, 41-3, 43-1 and 43-2 and I. T. 1273. While an income tax case, it involves questions primarily of statutory construction, rather than of accounting.

In detail, the questions presented are:

1. May an obligation to render services (as distinguished from an obligation to pay money), be the basis of an accrued liability?
2. May "a fair estimate" of future costs be the basis of an accrual deduction?
3. Is a decision of the Tax Court properly affirmed when it is predicated upon major and vital findings of fact directly contrary to the unquestioned documentary evidence in the case?
4. Was petitioner's method of accounting and reporting for the year in question consistent with its manner of accounting and reporting for prior years?
5. Was the Tax Court obliged to determine the correct measure of both income and expense for the year in question?

* So in Original.

## Statutes and Regulations Involved

The statutes and regulations involved herein as above described are set forth in Appendix C hereof.

## Specifications of Errors to be Urged

The Circuit Court of Appeals erred:

1. In holding that an obligation to render services (as distinguished from an obligation to pay money) may not be the basis of an accrued liability.
2. In holding that a fair estimate of future costs may not be the basis of an accrual deduction.
3. In affirming a decision of the Tax Court predicated upon major and vital findings of fact directly contrary to the unquestioned documentary evidence.
4. In holding that proof of the use of a method of accounting and reporting income from long-term construction contracts used by petitioner in 1933-1934 under identical conditions existing in 1937-1938 is not proof of consistency of method of reporting in 1937-1938.
5. In holding that the Tax Court was not obliged to determine the correct measure of both petitioner's income and expense for the year in question.

## The Reasons Relied on for the Allowance of the Writ.

1. The Circuit Court of Appeals, Second Circuit has decided a Federal question (i. e. under a Federal tax statute) in a way probably in conflict with decisions of this Court.

Before the Tax Court and the Circuit Court petitioner contended that an obligation to render services (as distinguished from an obligation to pay money) is a proper basis of an accrued liability.

and

> "A fair estimate of future costs may be the basis of an accrual deduction."

On these points the Circuit Court held:

> "Here the work for which the deduction is sought was unperformed and its cost was, as we have already indicated, no more than a fair estimate. Such a deduction as the taxpayer seeks had not 'accrued during the taxable year' and, therefore, did not meet the requirements of Section 23 (a) of the Revenue Act of 1936."

It is respectfully submitted that this holding is in conflict with the holding of this Court in *United States* v. *Anderson*, 269 U. S. 422 (1926). In that case a taxpayer on the accrual basis entered in 1916 a reserve for taxes on munitions made and sold in 1916. The taxes were not assessed, did not become due, and were not exactly computed until 1917. The Supreme Court held that said reserve was properly deductible in 1916.

The Court stated at page 440:

> "* * * The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year, the total costs and expenses attributable to the production of that income during the year. The reserve for munition taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained."

At page 441, the Court stated:

> "In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decisions were concerned, the taxes had accrued."

The decision of the Circuit Court of Appeals, Second Circuit, is also in conflict with the decision of this Court in the case of *American National Co.* v. *United States*, 274 U. S. 99 (1927); (usually cited in connection with the *Anderson* case).

This case concerned an agreement to pay a bonus during the life of discounted notes. A deduction was allowed for a reserve for bonuses payable in future years, under contracts made in taxable year.

In the instant case the liability to perform the prepaid work without further compensation was admitted and fixed in the year of the prepayment and, obviously, these expenses of performing said prepaid work were attributable to the production of the prepaid income. Hence under the rule of the *Anderson* case such expenses "must have been deducted from" the prepaid income "before the net results of the operations for the year could be ascertained." With this rule the opinions below are in conflict.

2. The Circuit Court of Appeals, Second Circuit has decided a Federal question in conflict with the decisions of other Circuit Courts of Appeal on the same questions.

By forcing petitioner to postpone deduction of the expenses of performing the prepaid work until said expenses were actually incurred, the Circuit Court has limited petitioner to a cash basis method of reporting these expenses, whereas the prepaid income was reported on the accrual basis.

It is respectfully submitted that the decision of the Circuit Court of Appeals, Second Circuit is in conflict with the decisions of the following Circuit Courts on the same questions:

*Fourth Circuit:*

*Bonded Mortgage Co. of Baltimore* v. *Commissioner*, 70 F. 2d, 341, C. C. A. 4, 1934.

In that case the Court stated at page 342:

> "The taxpayer's principal contention here is that the treatment of its income and out-go must be similar; * * * or, in other words, that both sides of the taxpayer's ledger must be treated alike; * * *
>
> "We are clearly of the opinion that the taxpayer's main contention is sound. Both sides of the ledger must be treated alike; otherwise its true income will not be reflected by the accounting * * *"

and at page 343:

> "* * * If, as illustrated by these cases, the taxpayer is not permitted to adopt inconsistent methods of bookkeeping for income and expenses respectively neither is the Commissioner. The principle is so entirely just and the law so plain that the point needs no further elaboration, * * *"

*Sixth Circuit:*

*Ohmer Register Company* v. *Commissioner*, 131 F. (2d) 682, C. C. A. 6, 1942.

In that case the Court said at page 686:

> "The essence of the accrual method of keeping accounts and making returns is that the right to receive not the actual receipt determines whether an amount should be included in gross income. The right accrues when a right to receive the amount becomes fixed. *Spring City Foundry Co.* v. *Commissioner*, 292 U. S. 182, 184. Correspondingly, the right to deduct an expense item accrues when the fixed obligation is incurred, even though the amount may be diminished by subsequent events. Both sides of the ledger must be treated alike."

The Circuit Court of Appeals, Sixth Circuit, in the case of *Air-Way Electrical Appliance Corporation* v. *Guitteau*, 123 F. 2d 20, C. C. A. 6, 1941 held at page 22:

> "* * * to divide the transaction and to place part of it upon an accrual basis and part of it on a cash basis * * * does not reflect true income."

*Tenth Circuit:*

> *United States* v. *Amalgamated Sugar Company*, 72 F. (2d) 755 at 759, C. C. A. 10, 1934.

> "The right to receive a definite sum as distinguished from its receipt and the fixed obligation to pay expenses as distinguished from actual payment, accrue items for income tax purposes if taxpayer uses the accrual system of keeping its books of account."

3. The United States Circuit Court of Appeals has decided important questions of Federal Law which have not been, but should, be settled by this Court. These questions are:

(a) Is there a distinction between an obligation to render services and an obligation to pay money? If no such distinction exists, then the decision in the case of *United States* v. *Anderson* (*supra*) and cases in harmony therewith are controlling and the decision herein must be re-

versed. If there is a distinction between these twin obligations, this distinction has never been passed on by this Court and should be settled by it.

The Circuit Court of Appeals made its decision hereupon as follows:

> "The liability for the estimated deduction clearly had not accrued during the year in which deduction was sought. The only thing which had accrued was the obligation to do the work which might result in the estimated indebtedness after the work was performed.
>
> "It is well settled that deduction may only be taken for the year in which the taxpayer's liability to *pay* becomes definite and certain even though the transactions (such as the *contract* in the present case*) which occasioned the liability, may have taken place in an earlier year (citing cases discussed infra). Here the work for which the deduction was sought was unperformed and its cost was, as we have already indicated, no more than a fair estimate. Such a deduction * * * had not 'accrued during the taxable year' * * *"

From the foregoing, we believe it is a fair statement to say that the Circuit Court of Appeals felt that the liability had not accrued because of two facts, viz:

(1) There was no present obligation to *pay*, as distinguished from a present obligation to render services which obligation was recognized by the Court.

(2) The cost of rendering the services was, of necessity "a fair estimate" which the Circuit Court of Appeals implies may not be the basis of an accrued liability.

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* Lest the Court be misled, it should be pointed out here that petitioner does not, and never did, contend that the expense liabilities in question accrued upon the signing of the contract. Petitioner's contention is that these expenses accrued in the same period as the income which they produced, i.e. when the prepaid income was received it accrued as *gross* income and must be reduced to *net* income in that period by accruing the cost of performing the prepaid work as a deduction.

The Circuit Court of Appeals' distinction between an obligation to render services and an obligation to pay money is an unreal one in both law and accounting. Rendering services necessitates expending money. An obligation to render services is the equivalent of an obligation to pay money. This is expressly recognized by Regulations 101, Article 41-1, applicable herein, which provides:

> "* * * Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. * * *"

The equivalence of an obligation to render services and an obligation to pay money from an accounting standpoint is recognized by Montgomery, Sixth Edition, *Auditing, Theory and Practice,* which states at page 302:

> "When items such as * * * advances received on uncompleted contracts involve a substantial obligation to render services and failure of performance may call for liquidation in cash, or when expenditures will be required within the ensuing period to realize the earning included in the deferred items, there can be no objection to including such items among the current liabilities."

(b) The Tax Court was obliged to determine the correct measure of both income and expense. Then if the said income and expense were found not as reported the correct net income could be determined under the rules of the Tax Court.

In its petition to the Tax Court (Board of Tax Appeals) petitioner set forth in detail all of the facts pertinent to its income and expense for the fiscal year in question and asked that its taxes be determined in accordance with such facts and that the claimed deficiency be declared illegal and void.

On the hearing of this matter petitioner proved in detail the items of both its income and expense.

The Tax Court had before it for determination the question of the net taxable income of petitioner for the year in question. It was its statutory obligation to determine this question.

In this case the Tax Court clearly indicated that petitioner had reported too much income by accruing uncertified contract work performed and had reported too much expense by accruing the expenses in question. It permitted the accrued income to stand but disallowed the accrued expenses in question, thus creating a situation where petitioner would be forced to pay taxes on net income not realized. The Tax Court was obligated to determine (in principle) petitioner's net income.

It has not made this determination.

The Circuit Court of Appeals did not pass on this question and as far as petitioner knows the question has never been passed on by this Court.

4. The Circuit Court of Appeals has so far departed from the accepted and usual course of judicial proceedings, or so far sanctioned such a departure by the Tax Court of the United States as to call for an exercise of this Court's power of supervision.

The findings of the Tax Court are in major and vital respects directly contrary to the unquestioned documentary evidence in this case, viz:

(a) Petitioner proved that its manner of reporting its income and expense from long term contracts was not of its own choosing but was forced upon it by the action of respondent in 1933 (see page 3 hereof).

(b) Petitioner proved that its method of accounting and reporting for the fiscal year in question was consistent with its method of accounting and reporting for previous years.

The Tax Court held:

> "The evidence showed that other instances asserted by petitioner to be similar were in reality no more than proper accruals of actually incurred expenses."

The documentary evidence (the books of petitioner for 1934) show that for that year there was accrued as income retained percentages held by the Treasury Department pending petitioners removing a cofferdam and a $17,000 liability being the estimated cost of removing the same (see Petitioner's Exhibit 20, fol. 724).

The Circuit Court held "the contention that the deduction of future expenses was consistent with the taxpayer's former accrual method of accounting clearly is without substance fortified as it is by only a single entry some years before." (Note: This differs radically from the Tax Court finding.)

[There were other accruals there too, but space does not permit the development of the details thereof.]

(c) Petitioner proved the reasons for accruing retained percentages and the facts concerning the same.

The Tax Court found:

> "It returned as income stipulated percentages which under that contract the City of New York reserved the right to and did retain, and which petitioner could not demand or lay claim to as a matter of right until performance was complete; although under those circumstances the liability to pay was not yet sufficiently definite to warrant accrual (Tr. fol. 251) * * * although the amounts so withheld were greater than the expense items which petitioner seeks to accrue and deduct and would more than offset them * * *" (Tr. fol. 252).
>
> "* * * and for the securing of which it would be required to undertake additional obligations" (Tr. fol. 255).

The documentary evidence (estimates of the City of New York) showed that up to June 11, 1938, petitioner had al-

ready received $444,000 of such retained percentage of $529,818.24 accrued by the substitution of securities (Petitioner's Exhibit 5, sheet 19), and the contract showed that to secure them it would not be required to undertake any additional obligations (Petitioner's Exhibit 3).

The finding in question is contrary to the proven fact.

(d) Petitioner proved that if the accruals of expense in question had not been made there would have been a distortion of income.

The Tax Court held:

> "On the contrary in both theory and result there is every probability that a distortion of income would follow upon the adoption of such a procedure" (Tr. fol. 266).

The documentary evidence (i. e., the bill of particulars taken from petitioner's cost records) shows that the actual cost of the work for which the accruals were made was $339,089.67. Obviously, if the accruals had not been made there would have been a distortion of income. The finding in question is contrary to the proven fact.

All of these facts are major and vital herein.

There is in the record not the slightest shred of evidence to support the above findings of the Tax Court.

It is inconceivable that the Circuit Court of Appeals could affirm a judgment of the Tax Court based on findings of such important character directly contrary to the unquestioned documentary evidence herein.

## The Importance of a Review of the Questions Involved Herein

That a review of the questions herein is desirable is indicated by the following quotation from Montgomery Federal Taxes on Corporations, Gross Income and Deduc-

tions, pages 835. With the opinions of Dr. Montgomery, this Court may or may not fully agree. The fact that the author of a standard text on the subject should find it necessary to characterize so critically the actions of respondent and the lower courts as "loaded with inconsistencies" itself shows the need for a restatement by this Court of the principles so well enunciated in the cases of *United States* v. *Anderson* (*supra*) and *American National Company* v. *United States* (*supra*).

This quotation from Montgomery, above referred to, is as follows.

> "The rulings and decision of the Treasury and Board dealing with accruals and the accrual method of accounting are loaded with inconsistencies. The fault has been not so much with the formal regulations as with their administration. When items of income arise or are collected in one period and part of the income belongs to a later period, good accounting practice requires that reserves be set up so that the first period will not have the benefit of unrealized and hence fictitious income * * *. The same mistaken attitude is evident in the Treasury's treatment of certain deferred expenses. * * * The trouble seems to arise from the confusion of 'accrued' with 'due and receivable' and 'due and payable.'
>
> "It is not a matter for legislative relief. There has been adequate relief in the laws for years. Section 41 requires the use of a method of accounting which clearly reflects the income. Section 42 requires the accounting for all items of gross income by proper accounting methods, authorized under Section 41 which clearly reflect the income. Section 43 authorizes the deduction of expense in such period as most clearly reflects the income * * *. The proper approach is admirably set forth in *Bonded Mortgage Co. of Baltimore* v. *Commissioner*, 70 F. (2d) 341.
>
> * * * * * * * * *
>
> "The Treasury in many cases, and the Board at times have ignored the basic principles in *U. S.* v. *Anderson* (269 U. S. 422), which is that the early in-

come tax laws were changed to enable taxpayers 'to keep their books and make their returns according to scientific principles by charging against income earned during the taxable period, the expense incurred and properly attributable to the process of earning income during the period.' " (Montgomery Federal Taxes on Corporations Gross Income and Deductions, p. 835.)

## Conclusion

For the reasons stated, it is respectfully submitted the writ of certiorari prayed for herein should be granted to the end that the mandate of the United States Circuit Court of Appeals, Second Circuit, herein may be reviewed and reversed and for such other and further relief as may be just and proper.

October 16, 1944.

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